TAX COURT OF THE UNITED STATES

Docket No. 1295-68

GEOGHEGAN & MATHIS, INC. - - - - *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE - - *Respondent*

55 T. C. No. 68
Filed January 27, 1971
[Headnote Omitted]

OPINION

TANNENWALD, *Judge:* Respondent determined deficiencies in the income taxes of petitioner as follows:

Fiscal year ending	Deficiency
February 28, 1963	$ 7,924.65
February 29, 1964	6,469.53
February 28, 1965	15,917.53

The parties have disposed of all the issues except that relating to a deduction in 1965 under section 616(a) or section 162(a)[1] for a certain claimed development expenditure relating to petitioner's limestone quarry.

All of the facts have been stipulated and are found accordingly.

Petitioner, Geoghegan & Mathis, Inc., is a Kentucky corporation whose principal place of business, at the time of

[1] All references are to the Internal Revenue Code of 1954 unless otherwise specified.

filing the petition herein, was Bardstown, Kentucky. Its return for the taxable year ending February 28, 1965 was timely filed with the district director of internal revenue, Louisville, Kentucky.

Petitioner's principal business is the operation of limestone quarries. In 1959, petitioner purchased the fee title to a tract of land near Bardstown, Kentucky. Prior to petitioner's purchase, it had been determined that the tract contained limestone in commercially marketable quantities and that such limestone lay under the entire surface of the tract.

A gas pipeline crossed the central portion of the tract purchased by petitioner. The owner of the pipeline, Louisville Gas & Electric Co. (hereinafter the utility company) possessed a perpetual right-of-way or easement across the tract for the purpose of constructing and maintaining this pipeline. Petitioner's title to the tract was specifically made subject to this right-of-way. The right-of-way agreement contained the following clause:

> The said grantors, their heirs, personal representatives and assigns, shall have the right fully to use and enjoy the said premises except for the purposes herein granted to said grantee, his heirs, personal representatives and assigns.

In 1959, petitioner began extracting the limestone on the western boundary of the tract by using the open pit method. This method utilized a vertical mining face and a horizontal mining floor. The original face and floor were established by excavation. Subsequently, the method by which the limestone was removed involved essentially two steps. First, the earth overburden which covered the limestone formations was removed by excavation. Second, the limestone was removed from the face of the mine by blasting and drilling.

As more limestone was extracted, petitioner's mining operations necessarily came closer to the pipeline. The existence of the pipeline and the right-of-way impeded further mining operations. The existing mining face could no longer be advanced unless the pipeline was removed.

Petitioner's officers negotiated with the utility company concerning relocation of the pipeline. On January 15, 1964, an agreement was reached whereby petitioner granted the utility company a new easement or right-of-way around the northern and eastern edges of the tract and the utility company surrendered its old right-of-way or easement to petitioner. As part of the arrangement, petitioner also agreed to bear the costs of relocating the pipeline on the new easement or right-of-way.

During petitioner's taxable year ending on February 28, 1965, the pipeline was relocated at a cost to petitioner of $14,682.78, which petitioner deducted as a development expenditure in addition to its deduction for depletion. Petitioner's continuing mining operations subsequently extended the mining face into that portion of the tract which was originally northeast of the earlier location of the pipeline.

Resolution of the issue in this case turns upon whether the cost to petitioner of relocating the utility company's pipeline represents, as petitioner contends, a development expenditure deductible under section 616(a)[2] or an ordi-

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[2]SEC. 616. DEVELOPMENT EXPENDITURES.

(a) In General.— * * * [T]here shall be allowed as a deduction in computing taxable income all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed. This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures.

(*Footnote continued on following page.*)

nary and necessary business expense deductible under section 162(a) or, as respondent contends, a capital item chargeable to petitioner's depletion account. In essence, petitioner argues that the expenditure added nothing to its full rights to the limestone stemming from its fee ownership of the land, was a mere cost of exploiting its pre-existing rights, and was consequently a legitimate development expenditure. Respondent counters with the argument that the expenditure was an essential element in the acquisition by petitioner of a right of access, that it represented the cost of obtaining a property right, that realistically it should be treated as part of the cost of the mineral rights themselves, and that therefore it is not a deductible expense but rather a depletable item. We agree with respondent.

The thrust of petitioner's argument with respect to section 616(a) is that, since the purpose of its arrangements with the utility company was to obtain access to the limestone with respect to which it already owned all mineral rights, its expenditure for relocation of the pipeline falls within the same category as expenditures for roads with respect to an open pit mine (*Amherst Coal Company* v. *United States*, 295 F. Supp. 421 (S.D. W.Va. 1969)) or shafts and tunnels with respect to subsurface mining (see *United States Gypsum Company* v. *United States*, 206 F. Supp. 744, 753 (N.D. Ill. 1962); S. Rept. No. 781, 82nd

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The predecessor of section 616(a) was section 23(cc) of the 1939 Internal Revenue Code, added by section 309(a), Revenue Act of 1951, 65 Stat. 452, 486-487. See S. Rept. No. 781, Part 2, 82nd Cong., 1st Sess., pp. 21-22, 1951-2 C.B. 545, 559, for a clear statement of the purposes of section 23(cc). See also H. Rept. No. 586 (Ways and Means Committee), 82nd Cong., 1st Sess., pp. 30-31, 107-108, 1951-2 C.B. 357, 379-380, 434-435; S. Rept. No. 781, Part 1 (Finance Committee), 82nd Cong., 1st Sess., pp. 43-45, 1951-2 C.B. 458, 489-490; S. Rept. No. 781, Part 2 (Finance Committee Supp. Rept.), 82nd Cong., 1st Sess., pp. 21-22, 1951-2 C.B. 545, 558-560; H. Rept. No. 1213 (Conference Committee), 82nd Cong., 1st Sess., p. 71, 1951-2 C.B. 622, 625-626; Report of Staff of Joint Committee on Internal Revenue Taxation (Oct. 1951), pp. 25-26, 1951-2 C.B. 287, 306-307.

Cong., 1st Sess.). Compare *Clear Fork Coal Company* v. *Commissioner*, 229 F. 2d 638, 643-644 (C.A. 6, 1956), reversing 22 T.C. 1075 (1954); *Repplier Coal Co.* v. *Commissioner*, 140 F. 2d 554 (C.A. 3, 1944), affirming a Memorandum Opinion of this Court; *Alsted Coal Co.* v. *Yoke*, 104 F. Supp. 606 (N.D. W.Va. 1952), affd. 200 F. 2d 766 (C.A. 4, 1952); *Guanacevi Mining Co.* v. *Commissioner*, 127 F. 2d 49 (C.A. 9, 1942), affirming 43 B.T.A. 517 (1941). See also *Commissioner* v. *H. E. Harman Coal Corp.*, 200 F. 2d 415, 418 (C.A. 4, 1952). In so arguing, petitioner relies heavily on *Kennecott Copper Corporation* v. *United States*, 347 F. 2d 275 (Ct. Cl. 1965).

It cannot be gainsaid that petitioner had, prior to the arrangement with the utility company, been vested with fee title to the minerals themselves. But the fact remains that the *right* of access to those minerals was impaired by the right of the utility company to maintain its gas pipeline in perpetuity by virtue of the right-of-way agreement—a right which had sufficient attributes to be considered an interest in property. Cf. *Inaja Land Co., Ltd.*, 9 T.C. 727 (1947); *H. L. Scales*, 10 B.T.A. 1024 (1928). Compare also *Ebb B. Nay*, 19 T.C. 114 (1952); *Louis W. Ray*, 18 T.C. 438, 441 (1952), aff'd 210 F. 2d 390 (C.A. 5, 1954). Petitioner seeks to avoid this hard fact by pointing to the provision in the right-of-way agreement that "[t]he said grantors, their heirs, personal representatives and assigns, shall have the right fully to use and enjoy the said premises." In so doing, however, petitioner conveniently ignores the further qualifying language in that same provision, which adds "except for the purposes herein granted to said grantee, his heirs, personal representatives and assigns." Such qualifying language clearly impairs the prior reservation of full use and enjoyment.

We think it clear that by its arrangements with the utility company petitioner eliminated a property interest in favor of the latter and acquired a *right* of access to the

minerals which it did not previously have. Whatever may be the limits of the deductibility of expenditures for exploiting rights of access in the area of open pit mining,[3] either as development expenses under section 616 or as ordinary and necessary expenses under the so-called receding face doctrine (see section 1.612-2, Income Tax Regs.),[4] we think that payments for *rights of access* should not be included therein.[5] Compare *Commissioner* v. *Southwest Exploration Co.*, 350 U. S. 308 (1956). Such payments in reality represented an additional investment in petitioner's limestone deposit and, in our opinion, do not fall within the scope of "activity necessary to make a deposit accessible for mining." See *Santa Fe Pacific Railroad Company* v. *United States*, 378 F. 2d 72, 76 (C.A. 7, 1967); *Amherst Coal Company* v. *United States, supra*, 295 F. Supp. at 441. The payment was for a *right* to engage in an activity, not an expense of carrying out the activity as such.

We recognize that the approach of *Kennecott Copper Corporation* v. *United States, supra*, supports a contrary view. But, in our judgment, the Court of Claims in that case failed to distinguish between a payment for a right of

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[3]The legislative history, as well as the judicial and administrative treatment of the problem from as early as the Revenue Act of 1918, indicates that determinations were guided mainly by the experiences of subsurface mining operations. See Alexander and Grant, "Mine Development and Exploration Expenditures," 8 Tax L. Rev. 401 (May 1952). See also *Kennecott Copper Corporation* v. *United States*, 347 F. 2d 275, 286-312 (Ct. Cl. 1965); Levy and Simonds, "Capitalization of Mining Expenditures," 26 Taxes 203 (March 148). Cf. *Enterprise Coal Co.* v. *Phillips*, 12 F. Supp. 49 (M.D. Pa. 1935) (discussion of accounting for purchase of additional property), affirmed per curiam, 84 F. 2d 565 (C.A. 3, 1936).

[4]Compare Rev. Rul. 67-169, 1967-1 C.B. 159; Rev. Rul. 67-35, 1967-1 C.B. 159; Rev. Rul. 66-170, 1966-1 C.B. 159.

[5]We are bolstered in our conclusion that a distinction should be drawn between expenditures for rights of access and those simply to exploit rights of access by the cases holding that a portion of the cost of land not necessary for mining a deposit can and should be allocated to the basis for determining cost depletion. *Beaver Dam Coal Company* v. *United States*, 370 F. 2d 414 (C.A. 6, 1966); *Potts Run Coal Co.*, 19 B.T.A. 1, 5 (1930).

access and a payment to exploit an unimpaired right of access which concededly exists. Moreover, by emphasizing the purpose of the payor as distinguished from the objective fact of what was obtained for the payment, the Court of Claims seems to open the door to the deductibility under section 616 of the costs of creeping acquisitions of surface rights necessary to continue an open pit mining operation—a result which would do violence to the proper concept of the term "development expenditures." Cf. *Denise Coal Co.*, 29 T.C. 528, 550-551 (1957); *Manchester Coal Co.*, 24 B.T.A. 577 (1931). To the extent that the *Kennecott* case may be read to reach the conclusion urged by petitioner herein, we respectfully decline to follow it.

Perhaps in anticipation of our focusing on its acquisition of a right of access in the form of an interest in property represented by the outstanding right-of-way, petitioner has, in the alternative, sought to dissect the arrangements between it and the utility company. Thus, it contends that the consideration for the release of the right-of-way was solely the furnishing by petitioner of a substitute right-of-way and that, petitioner having thus obtained the unimpaired right of access, the payment of the cost of relocating the gas pipeline was simply an expenditure for exploiting its right of access. We disagree. We think it completely unrealistic to conclude that the utility company bargained its right-of-way exclusively for another right-of-way. It is clear to us that the bargain was the existing right-of-way and pipeline for another right-of-way *and* relocation of that pipeline. Nuances in language contained in the written documents and the lapse of time between the release of the right-of-way and the grant of the new right-of-way, on the one hand, and the formal undertaking to pay the relocation costs, on the other, are not persuasive. The arrangements between the petitioner and the utility company encompassed a single transaction. Cf. *Kennecott*

Copper Corporation v. *United States, supra,* 347 F. 2d at pp. 280, 283.

The foregoing rationale is equally dispositive of petitioner's further claim that such expenditures constitute an ordinary and necessary business expense under section 162(a). Compare *Mt. Morris Drive-In Theatre Co.,* 25 T.C. 272 (1955), affirmed per curiam, 238 F. 2d 85 (C.A. 6, 1956); *Hotel Sulgrave, Inc.,* 21 T.C. 619 (1954). In this connection, we note, without expressing an opinion with respect thereto, that petitioner offered no evidence as to its prior practice or the practice of the industry with respect to expenditures such as are involved herein. Compare *Kennecott Copper Corporation* v. *United States, supra,* 347 F. 2d at 300-305; see *Welch* v. *Helvering,* 290 U. S. 111, 113-115 (1933).

Decision will be entered under rule 50.

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

No. 71-1439

GEOGHEGAN & MATHIS, INC., - - *Petitioner-Appellant,*

v.

COMMISSIONER OF INTERNAL REVENUE, - - - - - *Respondent-Appellee.*

APPEAL FROM THE UNITED STATES TAX COURT.

Decided and Filed January 28, 1972.

OPINION OF COURT OF APPEALS

Before: EDWARDS and PECK, Circuit Judges, and McALLISTER, Senior Circuit Judge.

PECK, Circuit Judge. This is an appeal by the taxpayer, Geoghegan & Mathis, Inc., of Bardstown, Kentucky, to review a decision of the United States Tax Court which is reported at 55 T.C. 672 (1971). The only issue for determination concerns the deductibility for federal income tax purposes of $14,682.78 paid by the taxpayer-appellant during its taxable year ended February 28, 1965.

The appellant is a Kentucky corporation whose principal place of business is at Bardstown, Kentucky, and whose principal business is the operation of limestone quarries. In 1959, the appellant purchased the fee simple title to a tract of land near Bardstown. Prior to appellant's purchase, it had been determined that the tract contained lime-

stone in commercially marketable quantities and that such limestone lay under the entire surface of the tract.

An eight inch gas pipeline diagonally crossed the central portion of the tract approximately thirty inches below the surface. The owner of the pipeline, the Louisville Gas & Electric Company, possessed a perpetual easement for the purpose of constructing and maintaining this pipeline.

In 1959, the appellant began extracting the limestone on the western boundary of the tract, using the open-pit or open-face method of mining. The operation progressed from the west side of the property toward the east and northeast side. Mining operations were not initially affected by the pipeline, but by late 1963 the mining face had been brought near the pipeline. As the vertical face of the pit moved with the mining process, it necessarily came closer to the existing pipeline right of way. Ultimately the existing mining face could no longer be advanced unless the pipeline was removed.

Appellant's officers therefore entered into negotiations with the utility company concerning relocation of the easement and pipeline. A "Grant and Release of Easement" was executed on January 16, 1964, by the appellant and the utility company which released the existing right of way through the center of the tract and granted to the utility company a new easement around the eastern and northern boundaries of the tract. As part of the arrangement, the appellant agreed to bear the costs of relocating the pipeline within the new right of way. The relocation work was performed during 1964, and on December 4, 1964, the utility company invoiced the appellant for the cost of relocation in the amount of $14,682.78, which appellant paid on December 28, 1964. After relocation of the pipeline, the mine face was extended to the eastern portion of the tract.

In its federal income tax return for its taxable year ended February 28, 1965, the appellant claimed a deduction for the payment of $14,682.78 as a development expense

under § 616 (a) of the Internal Revenue Code of 1954.[1] The claimed deduction was disallowed by the Commissioner of Internal Revenue on the ground that the amount represented the cost of acquisition of land. All of the facts and exhibits were fully stipulated, and the Tax Court concluded that the payment in question represented the cost of a real property interest and as such could not be deducted, and upheld the Commissioner's determination of disallowance.

The appellant's main contention at trial and on appeal is that the sum expended for relocation of the pipeline and right of way was entirely deductible that year as a development expenditure as provided by § 616(a) of the Internal Revenue Code of 1954. The Commissioner's position is that the expenditure was not a development expense within the scope of this section but was a part of the capital cost of mineral rights to the limestone.

Section 616(a) allows a current deduction from taxable income for any expenditures incurred for the development of a mine if paid or incurred after the existence of minerals in commercially marketable quantities has been disclosed. There is no question that appellant's expenditures for relocation were incurred after the existence of minerals in commercially marketable quantities had been disclosed. Thus the only question here is whether the payment was "for the development of a mine or other natural deposit," as required before a deduction may be taken under § 616(a).

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[1]Section 616(a) of the Internal Revenue Code of 1954 provides:

> "Except as provided in subsection (b), there shall be allowed as a deduction in computing taxable income all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed. This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures."

Because "development" expenditures are not defined in the statute, an examination of the legislative history and judicial interpretations of this section is necessary to ascertain the intended scope of the term. Prior to 1951, mining development expenses were deductible during the "production" stage of a mining operation. Such expenses were considered as currently deductible operating expenses (or if extraordinary, deductible ratably as the benefited minerals were mined and sold). However, development expenses incurred after discovery of minerals, but during the mine's "development" stage, were required to be capitalized and were recoverable only through deductions for depletion. E.g., see *Clear Fork Coal Co.* v. *Commissioner*, 229 F. 2d 638 (6th Cir. 1956). In 1951, section 23(cc) of the Internal Revenue Code of 1939 was enacted to provide that all "development" expenses incurred after commercially marketable quantities of minerals were disclosed became currently deductible, whether incurred during the development or production stage of operation. The legislative history[2] of this enactment is relevant in that it clarifies what congress and the industry understood by the term "development expense."

The Committee reports accompanying Section 23(cc) indicate specific legislative intent to provide statutory assurance that mining operators using the percentage depletion

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[2]Section 23(ee) [sic] of the Internal Revenue Code of 1939, added by section 309(a), Revenue Act of 1951, 65 Stat. 452, 486-487 was the predecessor of section 616(a) of the 1954 Code. *See* S. Rept. No. 781, Part 2, 82nd Cong., 1st Sess., pp. 21-22, 1951-2 C.B. 545, 559, for a clear statement of the purposes of section 23(cc). See also H. Rept. No. 586 (Ways and Means Committee), 82nd Cong., 1st Sess., pp. 30-31, 107-108, 1951-2 C.B. 357, 379-380, 434-435; S. Rept. No. 781, Part 1 (Finance Committee), 82nd Cong., 1st Sess., pp. 43-45, 1951-2 C.B. 458, 489-490; S. Rept. No. 781, Part 2 (Finance Committee Supp. Rept.), 82nd Cong., 1st Sess., pp. 21-22, 1951-2 C.B. 545, 558-560; H. Rept. No. 1213 (Conference Committee), 82nd Cong., 1st. Sess., p. 71, 1951-2 C.B. 622, 625-626; Report of Staff of Joint Committee on Internal Revenue Taxation (Oct. 1951), pp. 25-26, 1951-2 C.B. 387, 306-307.

method should be allowed a full and separate deduction for development expenditures. From a study of the legislative history of this section and of the cases arising under it we find that the commonly accepted definition of development expense, "that activity necessary to make a deposit accessible for mining," to be consistent with the legislative intent and with virtually all the decisions treating this code section. (E.g.: *Santa Fe Pacific Railroad Co.* v. *United States*, 378 F. 2d 72, 76 (7th Cir. 1967), *Amherst Coal Co.* v. *United States*, 295 F. Supp. 421, 441 (S.D. W.Va. 1969).)

The appellant relies predominately upon the decision of the Court of Claims in *Kennecott Copper Corp.* v. *United States*, 347 F. 2d 275 (Ct. Cl. 1965). The Commissioner's position is that *Kennecott* was wrongly decided and should not be followed. The Tax Court recognized that *Kennecott* "supports a contrary view," and declined to follow it. 55 T.C. at 676.

In *Kennecott*, the taxpayer owned and operated a copper mine using the "open pit" method of stripping. From time to time it became necessary to widen the pit, causing the outside circumference of the mine to become larger and necessitating the moving of facilities and outbuildings further and further from the center. When the outer circle reached one boundary of Kennecott's property, negotiations were made with the neighboring owner, United States Smelting Refining and Mining Company (USSRMCO), with the resulting agreement that Kennecott would receive easements, rights and privileges over, on and under various surface tracts to strip, dump and leach (a process which obtains ore from waste earth). Kennecott received rights to only some of the minerals under the surface and obligated itself to replace all of USSRMCO's facilities that would be destroyed in the process. There was no conveyance of any fee interest to Kennecott. In consideration for all of the rights acquired, Kennecott paid USSRMCO about 14.5 million dollars, which Kennecott amortized over a nine-year

period as an ordinary and necessary expense of mining. The Commissioner contended that the expenditures made by Kennecott to acquire the various surface rights from USSRMCO should have been capitalized and returned to Kennecott through annual depletion charges, rather than being deducted as an ordinary expense.

The Court of Claims concluded that where surface rights were acquired in order to provide access to minerals of a producing mine, the expense of acquiring them was more related to their exploitation than to their acquisition, and therefore that Kennecott's expenses could be deducted as "development expenses". 347 F. 2d at 312.

In permitting Kennecott to amortize its $14.5 million expense in full over a brief period of years, the Court of Claims permitted the amortization of the full amount notwithstanding the finding that some part of the payment was for all the other rights acquired, including the main right to strip the surface, payment for which would admittedly be capitalized and recovered by depletion. More importantly, while recognizing the distinction "between the cost of acquiring the surface rights and the cost of exploiting them," the Court allowed Kennecott to amortize the replacement costs as being for "acquisition," not for exploitation of the surface. 457 F. 2d at 285.

The appellant owned the fee title to all the minerals in the tract of land in question. When it purchased the land the company was aware of the dominant estate owned by the gas company for its pipeline. The appellant was also aware of the fact that access could not be had to the limestone without relocation of the pipeline; therefore, the right of access to the minerals was impaired by the right of the utility company to maintain its pipeline through the center of the tract. The purchase of this right and the concomitant relocation of the pipeline by the appellant was an essential element in the acquisition of the right of access to the minerals, and therefore must be treated as part of the cost of

the mineral rights themselves. It is a depletable item, and not deductible under § 616(a).

We decline to follow the *Kennecott* decision because we feel that the Court of Claims failed to distinguish between the payment for a right of access to minerals and the payment for exploitation of minerals to which a right of access already exists. There is no "activity" involved in the former, and thus expenses for payment of a right of access should not be deducted as development expenses.

The Tax Court's holding that the cost of obtaining the right to acquire access to minerals was not currently deductible is in accord with the decision of this Court in *Beaver Dam Coal Co.* v. *United States*, 370 F. 2d 414 (6th Cir. 1966). In that case, the owner of coal rights below the surface separately purchased surface rights so that operating companies could strip to reach the coal. The owner was often forced to purchase much more surface area than he needed at a price higher than the non-coal area would normally command. This Court held that the company should add to its depletable cost basis of the minerals not only the per acre cost of the surface to be destroyed, but also the premium paid for the non-coal acres in excess of the fair market value. Thus, the cost to the company of the land it did not need was for acquisition of the right to strip mine the desired surface, which is the right to obtain access to the coal. This expenditure was therefore properly capitalized and recovered through depletion. 370 F. 2d at 417.

For the reasons hereinabove set forth, and for those contained in the opinion of the Tax Court, 55 T.C. 672 (1971), *supra*, the judgment of that court is affirmed.

INTERNAL REVENUE CODE OF 1954, SECTION 616

DEVELOPMENT EXPENDITURES

Sec. 616. (a) In General.—Except as provided in subsection (b), there shall be allowed as a deduction in computing taxable income all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed. This section shall not apply to expenditures for the acquisition or improvement of property of a character which is subject to the allowance for depreciation provided in section 167, but allowances for depreciation shall be considered, for purposes of this section, as expenditures.

(b) Election of Taxpayer.—At the election of the taxpayer, made in accordance with regulations prescribed by the Secretary or his delegate, expenditures described in subsection (a) paid or incurred during the taxable year shall be treated as deferred expenses and shall be deductible on a ratable basis as the units of produced ores or minerals benefited by such expenditures are sold. In the case of such expenditures paid or incurred during the development stage of the mine or deposit, the election shall apply only with respect to the excess of such expenditures during the taxable year over the net receipts during the taxable year from the ores or minerals produced from such mine or deposit. The election under this subsection, if made, must be for the total amount of such expenditures, or the total amount of such excess, as the case may be, with respect to the mine or deposit, and shall be binding for such taxable year.

(c) Adjusted Basis of Mine or Deposit.—The amount of expenditures which are treated under subsection (b) as deferred expenses shall be taken into account in computing the adjusted basis of the mine or deposit, except that such

amount, and the adjustments to basis provided in section 1016(a)(9), shall be disregarded in determining the adjusted basis of the property for the purpose of computing a deduction for depletion under section 611.

TREASURY REG. § 1.616-1 (1960)

Development expenditures—(a) *General rule.* Section 616 prescribes rules for treating expenditures paid or incurred during the taxable year by the taxpayer for the development of a mine or other natural deposit (other than an oil or gas well). Development expenditures under section 616 are those which are made after such time when, in consideration of all the facts and circumstances (including actions of the taxpayer), deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. Under section 616(a), a taxpayer is allowed a deduction for development expenditures whether or not such expenditures are made in the development or production stage of the mine or other natural deposit. Under section 616(b), the taxpayer may elect to defer development expenditures made in the development or producing stage and to deduct such expenditures ratably as the minerals or ores benefited are sold. While the mine or other natural deposit is in the development stage, the election applies only to that portion of the development expenditures which is in excess of net receipts from the mine or other natural deposit. See § 1.616-2 for rules with respect to the election to defer. It is not necessary that the taxpayer incur the development costs directly. He may engage a contractor to make the expenditures on his behalf.

(b) *Expenditures to which section 616 is not applicable.* (1) Section 616 is not applicable to development expenditures which are deductible for the taxable year under any other provision of the internal revenue laws.

(2) Section 616 is not applicable to expenditures which are reflected in improvements subject to allowances for depreciation under sections 167 and 611. However, allowances for depreciation of such improvements which are used in the development of ores or minerals are considered development expenditures under section 616. If such improvements are used only in part for development during a taxable year, an allocable portion of the allowance for depreciation shall be treated as a development expenditure.

(3) Section 616 is applicable to development expenditures paid or incurred by a taxpayer in connection with the acquisition of a fractional share of the working or operating interest to the extent of the fractional interest so acquired. The expenditure attributable to the remaining fractional share shall be considered as part of the cost of his acquired interest and shall be capitalized and recovered through depletion allowances. For example, taxpayer A owns mineral leases on undeveloped mineral lands. A agrees to convey an undivided three-fourths (¾) interest in such leases to B, provided B will pay all of the expenditures incurred during the development stage of the deposits on these leases. B may deduct three-fourths (¾) of such amount under section 616, but shall treat one-fourth of such amount as part of the cost of his interest, recoverable through depletion.

(4) The provisions of section 616 do not apply to costs of development paid or incurred by a prior owner which are reflected in the amount which the taxpayer paid or incurred to acquire the property. Such provisions apply only to costs paid or incurred by the taxpayer for development undertaken directly or through contract by the taxpayer. See, however, sections 381(a) and 381(c)(10) for special rules with respect to deferred development expenditures in certain corporate acquisitions.

(c) *Mine or other natural deposit.* Section 616 has reference to expenditures made for the development of a mine

or other natural deposit. Within an aggregated property, as that term is defined in section 614(b) and (c), or within a single tract or parcel of land, there may be more than one mine or other natural deposit. Where a property, as determined under section 614, contains more than one mine or other natural deposit, the taxpayer may deduct under section 616(a) the development expenditures made with respect to one of such mines or deposits, and may defer under section 616(b) the development expenditures made with respect to another of such mines or deposits. Where there is more than one mine with respect to a single underlying deposit, the taxpayer may deduct under section 616(a) the development expenditures made with respect to one of such mines, and may defer under section 616(b) the development expenditures made with respect to another of such mines. The taxpayer must treat consistently all development expenditures with respect to each such mine or other natural deposit in a taxable year. The taxpayer must make a separate determination of the units of minerals or ores benefited in a mine or other natural deposit (regardless of the computation of the depletion allowance) in order that deferred expenditures with respect to such mine or deposit may be deducted on a ratable basis. See paragraph (f) of § 1.616-2.

TREASURY REG. § 1.612-2 (1960)

Allowable capital additions in case of mines.—(a) *In general.* Expenditures for improvements and for replacements, not including expenditures for ordinary and necessary maintenance and repairs, shall ordinarily be charged to capital account recoverable through depreciation deductions. Expenditures for equipment (including its installation and housing) and for replacements thereof, which are necessary to maintain the normal output solely because of the recession of the working faces of the mine and which—

(1) Do not increase the value of the mine, or

(2) Do not decrease the cost of production of mineral units, or

(3) Do not represent an amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made

shall be deducted as ordinary and necessary business expenses.

(b) *Special rule.* For special provisions applicable to treatment of expenditures for certain exploration and development costs (other than for the acquisition, restoration, or betterment of improvements) with respect to minerals other than oil or gas, see sections 615 and 616 and the regulations thereunder.